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UNRELATED BUSINESS INCOME OF TAX-EXEMPT ORGANIZATIONS

INTRODUCTION

In surprising recognition of the axiom that "charity is a good thing," Congress has long permitted certain types of organizations to escape payment of federal income taxes. The Income Tax Act of October 3, 1913, 38 Stat. 172, first provided for this. Then arose two landmark federal court decisions¹ which spawned the "destination of income" theory: as long as an exempt organization paid its earnings over to charity or used the earnings for another exempt purpose, it could not be taxed on those earnings. The major premise was that if Congress chose to make an organization exempt from federal income tax, the source of the organization's income was irrelevant if its profits were used for the exempt purpose.

By 1950, however, several abuses of the tax exempt privilege had achieved notoriety. Congressional ire was finally aroused when New York University became the nation's largest manufacturer of noodles.² Under the "destination of income" doctrine, so long as the macaroni profits were turned over to the university (an exempt organization), no income tax was owed by the university.³ Congressional concern over the widespread entry of exempt organizations into the field of big business is illustrated by the following statement made by Congressman Sabath in the House of Representatives:

A year ago one of the South's profitable operations was turned into a tax-exempt foundation, involving its \$34,000,000 holdings. The community gets about \$400,000 in tax-exempt moneys—about equal to the taxes the company formerly paid locally. All of its other huge profits total is tax-exempt to the Federal Treasury.⁴

Thus, the net results of an exempt foundation entering the cotton business were: (1) a loss of federal revenue; (2) the local taxes, no longer paid, were diverted to charitable purposes; and (3) profits which were previ-

1. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924); *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938).

2. *See Mueller Co. v. Commissioner*, 190 F.2d 120 (3rd Cir. 1951).

3. *See supra* note 1.

4. 96 CONG. REC. 9274 (1950).

ously taxed could either be reinvested in the business or used to lower prices and severely undercut the tax-paying competition.

Mr. Sabath pointed out another significant abuse:

Our universities and colleges have gone into business in grand style under this strangely overlooked weakness in our laws. Union College recently purchased all of the properties of Allied Stores Corp., one of the largest national department-store chains. The same college recently acquired the Abraham & Straus property in Brooklyn for \$9,000,000 and immediately leased it back to Abraham & Straus at low rentals under an 80-year lease.⁵

The practice condemned by Mr. Sabath involved the notorious sale and leaseback transaction⁶ under which the exempt organization typically would borrow money to purchase a going business, and then immediately lease the business back to the seller, using the rents to amortize the loan. In this manner, exempt organizations could acquire property without investment of any capital whatsoever. In effect, the exempt organization was selling a part of its exemption by virtue of its ability to pay a higher price and charge a lower rental than a taxable buyer could afford to do because the exempt organization paid no taxes on the rents received. This practice was effectively eliminated by the Tax Reform Act of 1969.⁷

The widespread involvement of exempt organizations in business was further described by Representative Sabath:

Meanwhile, the involvement of educational institutions in the field of banking, real estate, commerce, and industry goes merrily on. Universities own haberdasheries, citrus groves, movies, cattle ranches, the Encyclopedia Britanica (owned by the University of Chicago) and a large variety of other enterprises. The University of Wisconsin controls patent pools and collects royalties. Universities and colleges, together with foundations, have an annual income from their business activities of well over a half billion dollars annually. Were this income not tax-exempt, they would pay \$173,000,000 in Federal taxes annually.⁸

Congress responded to these tax abuses by enacting the Revenue Act of 1950,⁹ which levied a tax (at the corporate rate) on the income of

5. *Id.*

6. 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 34.15 (1968).

7. Code section 514 was completely overhauled by section 121 of the Tax Reform Act of 1969 in order to reverse the result of *Commissioner v. Clay Brown*, 380 U.S. 563 (1965) and *University Hill Foundation*, 51 T.C. 548 (1969). The amendment to the 1954 Code imposes a tax on the unrelated income of exempt organizations in the ratio of debt financed income to the business or investment property. Such income is subject to tax if it arises from property acquired or improved with borrowed funds and the production of the income is unrelated to the organization's exempt purpose.

8. *Supra* note 4.

9. Revenue Act of 1950, ch. 994, § 301, 64 Stat. 906 (now INT. REV. CODE of 1954, §§ 511-14).

an exempt organization derived from carrying on business not substantially related to the exempt function of the organization. The purpose behind the legislation was not that of raising revenue, but rather of placing exempt organizations on an equal competitive footing with private enterprise when the exempt organization is engaging in a business unrelated to the purpose of their exemption. Senate Report No. 2375 reinforces this observation:

The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of Code Sec. 501 organizations enables them to use their profits tax-free to expand operations while their competitors can expand only with the profits remaining after taxes.¹⁰

The purpose of this paper is to definitionally analyze the concept of *unrelated business income*, as it applies to exempt organizations, through an examination of the Regulations, Rulings, and cases under the Internal Revenue Code of 1954. Special emphasis will be placed upon the tests and standards employed by the Internal Revenue Service to determine what type of business is "substantially related" to an exempt function. These standards will be evaluated in light of the avowed purpose of competitive equalization.

THE 1954 CODE—WHAT ORGANIZATIONS ARE EXEMPT?

Section 511(a) of the Internal Revenue Code of 1954 imposes a tax (at the corporate rate) on the unrelated business taxable income of the following types of exempt organizations: (1) "[A] trust created or organized in the United States and forming part of a stock bonus, pension, or profit sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries . . .;"¹¹ (2) state colleges and universities, or any corporation owned by a college or university;¹² (3) title holding corporations, organized to hold title to property, collect income therefrom, and turn over profits to another exempt organization;¹³ (4) organizations "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for

10. S. REP. NO. 2375, 81st Cong., 2d Sess. (1950), 1950-2 CUM. BULL. 483, 504. See also 6A MERTENS, *supra* note 6, at § 34.14. TREAS. REG. § 1.513-1(b) (1967) provides: "The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non-exempt business endeavors with which they compete."

11. INT. REV. CODE OF 1954, § 511(a)(2)(A). Such a trust is defined in INT. REV. CODE OF 1954, § 401(a).

12. INT. REV. CODE OF 1954, § 511(a)(2)(B).

13. INT. REV. CODE OF 1954, § 501(c)(2).

the prevention of cruelty to children or animals;¹⁴ (5) civic leagues which are not operated for profit, but which exclusively promote social welfare;¹⁵ (6) labor, agricultural, or horticultural organizations;¹⁶ (7) non-profit business leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues;¹⁷ (8) private, nonprofit clubs operated for pleasure or recreation;¹⁸ (9) fraternal beneficiary societies operated to provide insurance benefits under the lodge system,¹⁹ or other domestic fraternal associations operating under the lodge system which do not provide insurance benefits, but whose net earnings are devoted exclusively to religious, charitable, scientific, literary, educational, or fraternal purposes;²⁰ (10) voluntary employees' beneficiary associations organized to pay insurance benefits to members;²¹ (11) local teachers' retirement funds whose income consists of amounts received from public tax assessments, assessments on teaching salaries, and investment income;²² (12) local benevolent life insurance associations and certain other mutual companies where at least eighty-five percent of the income is derived from sums collected from members for the sole purpose of meeting losses and expenses;²³ (13) cemetery companies;²⁴ (14) credit unions and bank insurance companies;²⁵ (15) certain insurance companies whose income during the year does not exceed \$150,000;²⁶ (16) a trust formed to pay supplemental unemployment compensation benefits;²⁷ and (17) certain trusts forming part of a pension plan funded solely by employee contributions.²⁸

WHAT IS A "TRADE OR BUSINESS?"

The term "*unrelated* trade or business" is defined in Code section 513(a) as:

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14. INT. REV. CODE of 1954, § 501(c)(3).
 15. INT. REV. CODE of 1954, § 501(c)(4).
 16. INT. REV. CODE of 1954, § 501(c)(5).
 17. INT. REV. CODE of 1954, § 501(c)(6).
 18. INT. REV. CODE of 1954, § 501(c)(7).
 19. INT. REV. CODE of 1954, § 501(c)(8).
 20. INT. REV. CODE of 1954, § 501(c)(10).
 21. INT. REV. CODE of 1954, § 501(c)(9).
 22. INT. REV. CODE of 1954, § 501(c)(11).
 23. INT. REV. CODE of 1954, § 501(c)(12).
 24. INT. REV. CODE of 1954, § 501(c)(13).
 25. INT. REV. CODE of 1954, § 501(c)(14).
 26. INT. REV. CODE of 1954, § 501(c)(15).
 27. INT. REV. CODE of 1954, § 501(c)(17).
 28. INT. REV. CODE of 1954, § 501(c)(18).

Any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption

To be liable for the unrelated business income tax, an exempt organization must, of course, be engaged in a "trade or business." The Regulations refer to Code section 162 for a definition of "trade or business" as used in section 513. Code section 162, however, nowhere defines the term. One must therefore look to the Regulations, which, under Code section 513, indicate an intention to give the term the broadest possible meaning.²⁹

Generally, "business" may be defined as:

That which occupies the time, attention, and labor of men for the purpose of livelihood or profit, but it is not necessary that it shall be the sole occupation or employment. It embraces everything about which a person can be employed. . . . The doing of a single act pertaining to a particular business will not be considered engaging in or carrying on a trade or business, yet a series of such acts would be so considered.³⁰

Considering the above definition, one would suspect that "trade or business" contemplates doing an aggregate of separate and distinct movements or operations, all joined by some common purpose, and it is this aggregate that composes the contemplated "trade or business." Problems are encountered, however, when this theoretical definition is applied to a common practical situation. Hypothesize a nightclub which draws income from serving drinks, levying cover charges for entertainment, serving meals, checking coats, providing a parking service, and occasionally renting out the club for a private party on a flat fee basis. Two possible theories emerge as to what constitutes a "business" in the above example.

The ordinary running of the nightclub would certainly be considered a business under any theory. But the renting out of the facility only "occasionally" constitutes merely a single act of insufficient regularity to manifest a continuing desire to draw livelihood therefrom. The severable components of the nightclub business present a difficult problem. Is the primary business to be fractionalized into its aggregate components, each a separate business, so that when we talk about running a nightclub, we are really talking about the separate and distinct businesses of selling drinks, parking cars, checking coats, and serving meals? Or is the entire operation of the nightclub to be considered one business?

The distinction becomes important when considered in connection with the two other prerequisites for the imposition of the unrelated business income tax. According to section 512(a)(1) of the Code, the tax is

29. Treas. Reg. § 1.513-1(b) (1967).

30. BOUVIER'S LAW DICT. 143 (Baldwin ed. 1934).

imposed when three conditions are met: (1) when the exempt organization engages in a trade or business, (2) which is substantially unrelated to the exempt purpose of the organization, and (3) such trade or business is regularly carried on. If, for example, the exempt function of an organization is the selling of drugs to a hospital, and this accounts for 90% of its revenue, does the fact that the organization also occasionally sells drugs to the general public amounting to 10% of its gross revenue require the levying of the unrelated business income tax? Does the fact that an exempt organization publishes a journal and also sells advertising space require imposition of tax on the advertising revenue? Must the larger business aggregate be fractionalized into its component parts? The Regulations provide an affirmative answer:

Thus the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good-will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.³¹

The above Regulation promulgated in 1967 added a new dimension to the term "trade or business" regarding the frequency with which it is carried on. Senate Report No. 2375 illustrates what was originally meant for a business to be "regularly carried on:"

If a charitable organization exempt under 101(6) [now section 501(c)(3)] of the Code, gives an occasional dance to which the public is admitted for a charge, hiring an orchestra and entertainers for the purpose, this would not be a trade or business regularly carried on within the meaning of section 422 [now section 513]. Likewise, an organization which operates a sandwich stand during the week of an annual county fair is not regularly carrying on a trade or business. On the other hand, if an organization operates a public parking lot one day each week, the organization would be carrying on a trade or business. Similarly, if an organization owned a race track, this would not be considered an occasional activity, even though the track was operated only a few weeks every year, since it is usual to carry on such a trade or business only during a particular season.³²

Congress thus envisioned a business to be regularly carried on where there was some constant, periodic frequency to the activity. Early Regulations under the 1954 Code held a trade or business to be "regularly" carried on if it was pursued with a certain quantum of consistency and regularity so as to indicate a continuing purpose to derive income from the activity,³³ implying that if "one is kept more or less busy . . . the ac-

31. Treas. Reg. § 1.513-1(b) (1967).

32. S. REP. NO. 2375, *supra* note 10, at 559.

33. Treas. Reg. § 1.513-2(a)(3) (1958).

tivity is an occupation."³⁴

This rather literal interpretation of "regularity" became eroded as the Code was expanded through further Treasury Regulations. Notwithstanding an early expression of Congressional intent that an independent test of regularity prevail,³⁵ the Treasury Department, sensing that a major factor for imposition of the unrelated business income tax was the equalization of competition, grafted a normative factor upon the independent test which called for a comparison between the unrelated activity and the manner in which the activity is normally carried on in regular commercial channels. The following is offered for illustration:

[S]pecific business activities of an exempt organization will ordinarily be deemed "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of non-exempt organizations.³⁶

The Regulations explain that where a particular activity would be carried on by a commercial enterprise on a year-round basis, the conduct of the same activity by a tax exempt organization for only a few weeks will not be considered as regularly carried on.³⁷ The example given is the operation by a hospital auxiliary of a refreshment stand for a few weeks during a state fair. It would not be a trade or business regularly carried on because most commercial enterprises would operate on a year-round basis. However, another test is used where during the year there is a constant, periodic frequency to the activity. For example, the operation of a pay parking lot every Saturday during the year constitutes the regular carrying on of business notwithstanding the fact that most parking lots are open daily. This test is of little value because of the absence of sufficient criteria for predictability. Although operation every Saturday for a year is stipulated by the Regulations to be of sufficient periodic frequency, at what point will the activity become sporadic or intermittent? If the hospital auxiliary may operate a sandwich stand for fourteen days during the fair season, one would think that operating the parking lot for one day a month would qualify as business not regularly carried on. The result, however, is unpredictable.

A third example given by the Regulations provides another somewhat ludicrous result. Where a race track is operated by an exempt organization for several weeks out of the year, the IRS would apply the commercial enterprise test and label this business as regularly carried on because

34. *Snell v. Commissioner*, 97 F.2d 891, 892 (5th Cir. 1938).

35. S. REP. NO. 2375, *supra* note 10, at 559.

36. Treas. Reg. § 1.513-1(c)(1) (1967).

37. Treas. Reg. § 1.513-1(c)(2)(i) (1967).

racing is a seasonal business and most commercial race tracks do not operate the year round.³⁸ The truth of the last statement may be questioned, but even if one were to admit racing to be seasonal, the general commercial season is more apt to run several months than several weeks.

The issue has been considered in at least one Ruling on point. In 1968 the Commissioner considered the situation where a county fair association (exempt under section 501(c)(3) of the Code) featured as part of its fair program a two-week horse racing meet with pari-mutuel betting.³⁹ The organization received a fixed commission of a percentage of the total amount wagered and used the entire amount realized for its exempt purposes. After reasoning that such activity was not related to the exempt purpose of the organization, the Commissioner held that the two-week racing program was business regularly carried on. The reasoning employed paralleled the Regulations: since the races were operated exactly like other commercial races and other commercial race tracks operated on a seasonal basis, a two-week racing season, when compared to commercial horse racing, is business regularly carried on. The Ruling followed the Regulations insofar as the comparison to a commercial enterprise is concerned, however, it reduced a "season" to only two weeks.⁴⁰ This reasoning is completely incompatible with the holding that the operation of a refreshment stand for two weeks is not business regularly carried on. The distinction that racing is commercially a seasonal business while operation of a refreshment stand is a year-round business is a strained distinction, primarily because two weeks is not a "season," and secondarily, because many refreshment stands also operate seasonally. It would appear that if an exempt organization wished to conduct unrelated business activity, it would do well to operate sporadically, with a skewed frequency, and never

38. Treas. Reg. § 1.513-1(c)(2)(i) (1967).

39. Rev. Rul. 68-505, 1968-2 CUM. BULL. 248.

40. *But see* Maryland State Fair and Agricultural Society, Inc. v. Chamberlain, 55-1 T.C. ¶ 9399 (1955) (a jury returned a verdict that the carrying on of an annual horse racing meet by an exempt agricultural association during 7-10 days of the Maryland State Fair constituted business activity substantially related to the exempt function of the organization. The argument that the business was not regularly carried on was apparently not advanced, although it would have been proper to do so). *See also* Cooper Tire & Rubber Co. Employees' Retirement Fund v. Commissioner, 306 F.2d 20 (6th Cir. 1962) (the exempt trust was was held liable for unrelated business income tax upon profits derived from the leasing of twenty manufacturing machines to Cooper Tire & Rubber Co. Responding to the claim of defendant that one transaction was not business regularly carried on, the court said: "We do not think that a trust must necessarily engage in more than one venture in order to be regularly engaged in the business." *Id.* at 21. Another instance where a single venture has passed the test of regularity was the lease of a number of railroad tank cars to an industrial company. Rev. Rul. 60-206, 1960-1 CUM. BULL. 201.

for more than a day or two at a time. This would lessen the likelihood of the Commissioner finding a constantly recurring regularity.⁴¹ Also, the organization would do well to shun a seasonal business, since a seasonal, unrelated trade or business carried on for a week or two may well be found to be regular, while a non-seasonal business operated for more than two weeks could likely be found to be irregularly carried on.

A third factor which the Commissioner will consider when determining whether intermittent activities are regularly being carried on involves another comparison to commercial business activity. The Regulations provide that an intermittent activity will more likely be considered to be regularly carried on where such activities are "conducted without the competitive and promotional efforts typical of commercial endeavors."⁴² One would suppose that this factor would limit the amount of advertising or publicity an exempt organization might devote to its fund raising activities, yet if this *were* the meaning to be attributed, we would come to the absurd conclusion that charitable fund raising activities will be considered regular if carried on with an excess of enthusiasm.

The Regulations explain the provision in terms of systematic promotion of non-qualifying activity.⁴³ For example, if a college bookstore sells books primarily for the convenience of students and makes incidental sales to outsiders which do not qualify as related business, the store is free to promote the exempt activity. The non-exempt activity will not be considered regularly carried on unless it is "systematically and consistently" promoted.

It will be observed, however, that regularity refers to the frequency of the activity, a highly fluctuating and ambiguous variable. In attempting to define a point between regularity and irregularity, the Regulations confuse the issue by interposing two more ambiguous variables—"systematically" and "consistently." The attempt to relate promotion with the frequency of the activity provides at best only a secondary indicator since, although there is a direct relation between the two, frequency will lag an indefinite period of time behind promotion. Perhaps a better solution would have been to limit disqualifying sales to a certain percentage of gross receipts. If an excess of disqualifying sales were generated, an unrelated business tax would be imposed.

41. Treas. Reg. § 1.513-1(c)(2)(iii) (1967): "income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on merely because they are conducted on an annually recurrent basis."

42. Treas. Reg. § 1.513-1(c)(2)(iii) (1967).

43. Treas. Reg. § 1.513-1(c)(2)(iii) (1967).

RELATED OR UNRELATED?—A QUALITATIVE CONCEPT

Section 501 of the Internal Revenue Code exempts qualifying organizations from the payment of all federal income taxes; however, section 511, a qualifying provision, imposes a tax at the corporate rate on the "unrelated business taxable income" of the organization. Section 512(a)(1) defines "unrelated business taxable income" as the "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it," less certain deductions.⁴⁴ According to section 513 "unrelated trade or business" means "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption." Specifically decreed as unrelated are businesses where: (1) substantially all the work in carrying on such trade or business is performed for the organization without compensation;⁴⁵ (2) the trade or business is performed "primarily for the convenience of its members, students, patients, officers, or employees;"⁴⁶ and (3) the business involves the "selling of merchandise, substantially all of which has been received by the organization as gifts or contributions."⁴⁷ Thus, from reading the Code provisions, one arrives at the nebulous definition of "unrelated trade or business" as a trade or business not substantially related to the exempt function of the organization.

In attempting to refine the hazy distinction between related and unrelated business activity, the Regulations offer a number of standards which the Commissioner will employ in arriving at a determination. The first test asks the following question: Does the distribution of goods or performance of services from which the income in question is derived contribute importantly to the accomplishment of the organization's exempt purpose?⁴⁸ In other words, it makes no difference that the funds derived

44. INT. REV. CODE of 1954, § 512(b) excludes the following from the computation of unrelated business taxable income: dividends, interest, annuities, royalties, nonbusiness lease rental income, capital gains, income from research performed for federal, state, or local government, income from any research performed by a college, university, or hospital, and all income from research performed by an organization operated primarily for purposes of carrying on fundamental research. Deductions include a flat \$1,000 exemption, the § 170 charitable contributions deduction, operating loss deduction, and expenses which are directly connected with the carrying on of unrelated business.

45. INT. REV. CODE of 1954, § 513(a)(1).

46. INT. REV. CODE of 1954, § 513(a)(2).

47. INT. REV. CODE of 1954, § 513(a)(3).

48. Treas. Reg. § 1.513-1(d)(2) (1967).

further the exempt purpose of the organization. Rather, the business itself must relate "causally" to the exempt function. This factor provides an interesting contradiction. An organization is decreed exempt from taxation on the theory that it exists not to make a profit, but to collect income and spend it for certain worthy purposes, the implication being that such organizations are mere channels for worthy functions. The tax imposed on unrelated business income is designed to equalize an exempt organization with a commercial enterprise engaging in a similar business. To maintain that an organization may not engage in commercial activity because it works to the disadvantage of competitive enterprise, while the same organization is free to pursue a commercial activity that promotes its exempt purpose, ignores the existence of competitive enterprise engaging commercially in the same activity.⁴⁹ For example, a college bookstore, exempt from the unrelated business income tax under section 513(a)(2) of the Code, is arguably in direct and unfair competition with other tax-paying bookstores in a community. A pharmacy operated by a tax-exempt hospital for the purpose of selling drugs to hospital patients is deemed a related business since the exempt function of the hospital, curing illness, is furthered.⁵⁰ But this certainly presents direct competition with other pharmacies in a community.

A second factor utilized in determining whether business contributes importantly to the accomplishment of an organization's exempt purpose involves a comparison of the size and extent of the activity with the nature and extent of the exempt function.⁵¹ Where a business activity of an organization which in fact furthers the exempt purpose grows larger "than is reasonably necessary for the performance of such function," that portion of gross income which exceeds the reasonable needs of the organization will be considered unrelated business taxable income.⁵² While it is clear that the purpose of the Regulation is to prevent an organization's exempt function from becoming subordinate to its business activity, practi-

49. Caplan, *Limitations on Exempt Organizations: Political and Commercial Activities*, in NEW YORK CONFERENCE ON CHARITABLE FOUNDATIONS 265 (Sellin 1967 ed.). At page 288 Caplan states: "Under the Code we are faced with, at best, a hazy distinction which often does not remedy competitive abuses that concerned Congress in 1950. For example, an educational foundation which engages in publishing activities can be said to be in receipt of 'related' business income. Accordingly, it might well enter the book publishing business free of tax in sharp competition with fully taxable competitors. From this it can be seen that 'related' business income, which is non-taxable, can be a more serious problem to competitors than 'unrelated' business income which is subject to tax."

50. See, e.g., Rev. Rul. 68-374, 1968-2 CUM. BULL. 242.

51. Treas. Reg. § 1.513-1(d)(3) (1967).

52. Treas. Reg. § 1.513-1(d)(3) (1967).

cal application is difficult. Neither the Code nor Regulations give any indication of an appropriate ratio between gross income of the exempt organization and that amount (or percentage) which may permissibly be attributed to business activities.

A third factor in determining "relatedness" of business activity is the degree of commerciality with which it is carried on. The Regulations mention this as a function of "regularity," but it is clear from both the Regulations and the Rulings that if an organization conducts a business activity with all the flair of a commercial enterprise, the danger exists that the Commissioner will find that the purpose of the business is not to promote the exempt function, but to make money.⁵³ This might be considered a restatement of the "comparison of size" factor discussed above, insofar as the reaping of profits becomes the paramount objective of the business while the exempt purpose takes on secondary importance. Indicators of excessive commerciality for which the Commissioner will look include the size and extent of the business in comparison with the size and extent of the exempt function,⁵⁴ and the manner of promotion and advertising of the commercial activity.⁵⁵

THE TREASURY RULINGS AND JUDICIAL INTERPRETATION

An analysis of the published Revenue Rulings leads to the conclusion that the Commissioner does not make an exhaustive evaluation of the various factors enunciated by the Regulations when determining whether a given business activity is related to the performance of a certain exempt function. In addition, it appears that the standards of "relatedness" are applied inconsistently depending upon the type of exempt function being performed.

In 1957, the Commissioner ruled on certain business activities of an exempt agricultural organization, incorporated for the purpose of advance-

53. Mulreany, *Foundation Business Activity: Related and Unrelated Income*, in 9 NEW YORK UNIVERSITY CONFERENCE ON CHARITABLE FOUNDATIONS 179 (Sel-lin 1967 ed.). Mr. Mulreany states: "Another standard to be applied when we consider what the term 'not substantially related means, is the degree of commerciality which the questioned trade or business possesses. Section 513 does not require exempt organizations to conduct activities totally dissimilar from those conducted by commercial organizations. The thrust of the Regulations, however, indicates that the more commercial a trade or business, or to put it another way, the more similar an organization's trade or business becomes to a commercial enterprise, the more justification it must have that this trade or business relates to and furthers its exempt purpose." *Id.* at 187.

54. Treas. Reg. § 1.513-1(d)(3) (1967).

55. Treas. Reg. § 1.513-1(c)(2)(i) (1967).

ment and improvement of agriculture.⁵⁶ The Regulations under section 501(c)(5) of the Code under which the organization was granted its exemption specify the requirements for exemption:⁵⁷ (1) no net income may inure to the benefit of any individual member and (2) such organization must have as its objective "the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations." The charter of the organization in question, in addition to exempt activities, permitted the organization to market agricultural products for producers and purchase supplies and equipment for resale to such producers. In ruling that the sale of supplies and equipment to producers constituted a business not substantially related to the organization's exempt function, the Commissioner relied on the "relative-size-in-comparison" test:

In the usual case, the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further . . . the purpose for which the organization was granted exemption.⁵⁸

The words of the Ruling imply that a little business is of necessity unrelated. The application of a quantitative test to arrive at a qualitative determination is both confusing and inaccurate. In such a case where the marketing of a product is undertaken by an organization whose primary function is educational and instructive, the causal connection between the business and exempt function is totally absent, and the business is patently unrelated. A Ruling should be based on this ground where a relationship between *qualities* is being considered. The *quantitative* test used by the Commissioner is appropriate in two situations: first, when an organization's very exemption is drawn in question and, second, in determining whether an unrelated business is being *regularly* carried on. In the first instance, the size of an unrelated business activity is a critical factor when inquiring whether the function of an organization is really of an exempt nature, or whether it is essentially a facade for a comprehensive business. In the second situation, a quantitative test is useful in ascertaining whether an unrelated business activity is systematically being pursued.

A more recent Ruling on almost the identical issue lends credence to the above criticism.⁵⁹ Advice was requested as to whether an agricul-

56. Rev. Rul. 57-466, 1957-2 CUM. BULL. 311.

57. Treas. Reg. § 1.501(c)(5)-1 (1968).

58. Rev. Rul. 57-466, 1957-2 CUM. BULL. 311, 312.

59. Rev. Rul. 69-51, 1969-2 CUM. BULL. 159.

tural organization, exempt under Code section 501(c)(5), could be taxed on certain marketing activity. The organization's exempt function was "to promote the betterment of conditions of breeders of Angus cattle and to improve the breed generally" through a comprehensive educational and service program. As one of its "lesser" activities, the organization regularly sold cattle of its members on a commission basis. In holding this to be unrelated business activity, the Commissioner grounded his decision solely upon the absence of a causal relationship between the exempt educational function and the marketing of cattle:

In this case, the sale of cattle constitutes trade or business that is regularly carried on. The sale of members' cattle for a commission is not an activity coming within the ambit of section 501(c)(5) of the Code. . . . The sale itself neither promotes the betterment of conditions of cattle breeders nor improves the breed generally but is carried on for the convenience of members and the production of income. Furthermore, the sale is an activity *having no causal relationship to the performance of the organization's exempt purpose* and it does not contribute importantly to the accomplishment of that purpose.⁶⁰

A final example of marketing activities of an exempt organization is noted here to demonstrate the importance of the correct choice of exempt organization for the activities to be carried on. An exempt agricultural association was organized to "foster and encourage the breeding, proper development, and care of the better types of horses."⁶¹ In conjunction with these activities, the organization owned and operated a clubhouse which served as headquarters for its various activities. The clubhouse contained a bar, restaurant, and cocktail lounge for members and guests, and was operated on a year-round basis. The clubhouse provided over 50% of the organization's annual income, but less than 25% of the membership owned horses or had any connection with horse breeding or development. It is apparent that the social function of the organization was primary, and the agricultural functions of secondary importance. In ruling the operation of the club to be an unrelated business, the Commissioner drew attention to the fact that not incorporating as an exempt social club under section 501(c)(7) of the Code was fatal in

60. *Id.* (emphasis added). See also Rev. Rul. 59-330, 1959-2 CUM. BULL. 153 in which an exempt labor organization conducted semi-weekly bingo games to offset the expenses of maintaining its office building. While not directly considering the absence of a *causal* relationship, the Commissioner implied this test to be the controlling factor in labeling the bingo games "patently unrelated." A second factor enunciated by the Commissioner in considering "relatedness" was regularity so as "to indicate a continuing purpose of the organization to derive some of its income from such activity." This is incorrect and unnecessarily confusing. Regularity and relatedness are two separate and distinct concepts. The presence of one does not imply the presence of the other.

61. Rev. Rul. 60-86, 1961-1 CUM. BULL. 198.

reference to tax liability:

Although the operation of club facilities would be a necessary ingredient in carrying out the objectives of a social club as described in section 501(c)(7) of the Code, such facilities are not of primary concern to the furtherance of the purpose of an exempt agricultural organization.⁶²

Considering the fact that the bulk of the organization's membership joined for social rather than agricultural reasons, the unrelated business tax could have been avoided with little hardship had the organization been incorporated for the social purpose.

When one analyzes the treatment of hospitals with regard to the unrelated business income tax, a much more liberal set of standards arises. In three Rulings handed down in 1969, the Commissioner practically handed tax-exempt hospitals full freedom with respect to what kind of business they might engage in. While paying lip-service to the "causal, qualitative relationship" required between the exempt function of a hospital under section 501(c)(3) and the trade or business which may be engaged in without imposition of tax, the real standards used were quantitative. The qualitative standards enunciated were highly artificial.

As stated above, the hospital requesting the Ruling was exempt under Code section 501(c)(3). Aside from the exempt function of restoring and maintaining health, the hospital also operated the following businesses: (1) a gift shop patronized by patients, visitors making purchases for patients, and employees;⁶³ (2) a cafeteria and coffee shop primarily for employees and medical staff;⁶⁴ and (3) a parking lot for patients and visitors.⁶⁵ In all three cases, profits derived from the businesses were turned over to the hospital's general operating fund. In all three cases the businesses were ruled related to the exempt function of the hospital.

The reasoning employed by the Commissioner is quite a unique exercise in logic. The gift shop was ruled to be a related business insofar as it causally promoted the health and well-being of patients:

One of the purposes of the hospital is to provide health care for members of the

62. *Id.*

63. Rev. Rul. 69-267, 1969-1 CUM. BULL. 160: "The hospital maintains a gift shop operated by a full-time, salaried manager assisted by members of the hospital auxiliary. The gift shop sells candy, newspapers, books, magazines, flowers, and other small gift items. It handles rental orders for television sets for patients. It also operates a 'gift cart' that is taken throughout the hospital."

64. Rev. Rul. 69-268, 1969-1 CUM. BULL. 160: "The hospital operates a cafeteria and coffee shop in its main building primarily for its employees and medical staff. . . . Persons visiting patients in the hospital are permitted to use the facilities; however, the general public is not encouraged to use them."

65. Rev. Rul. 69-269, 1969-1 CUM. BULL. 160.

community. By providing a facility for the purchase of merchandise and services to improve the physical comfort and mental well-being of its patients, the hospital is carrying on an activity that encourages their recovery and therefore contributes importantly to its exempt purpose.⁶⁶

Similar reasoning was employed with respect to the parking lot and the cafeteria. Providing facilities for employees to eat while remaining on the premises promoted the efficiency of the hospital by insuring that they would be available for emergency situations.⁶⁷ Finally, a very ridiculous reason was employed to justify use of the cafeteria by visitors:

Visitation of patients constitutes supportive therapy that assists in patient treatment and encourages their recovery. By permitting visitors to use the hospital enables them to spend more time with the patients. This also contributes importantly to the exempt purpose.⁶⁸

The conclusion above is patently incorrect; there is no direct connection between visitors using the cafeteria and the amount of time spent with patients. Following such reasoning to its logical conclusion, a hospital could operate any business, from a gasoline station to a beauty shop, reaping huge profits tax-exempt on the ground that people using these facilities could spend more time with patients giving them "supportive therapy," and thereby promoting the exempt function of the hospital.⁶⁹

In holding that a business activity that increases the efficiency of an exempt function causally relates to that function, the Commissioner unnecessarily expands the concept of "causal relatedness." In prior Rulings, *relatedness* referred to a qualitative factor—a similarity of function. This set of 1969 hospital Rulings distorts the concept of *causality* by holding that an activity which promotes the efficiency of an exempt function might predictably be held to be related.

It must be remembered at this point that the purpose of the tax on unrelated business income was to prevent unfair competition between an exempt organization and private enterprise.⁷⁰ In this set of hospital

66. *Supra* note 63. The Ruling went on to chart an even more dubious qualitative relationship: "Furthermore, since it is to the hospital's advantage to keep its employees and medical staff on its premises throughout their working days, the sale of reading materials, candy, and other personal effects by the gift shop to hospital personnel increases the hospital's efficiency and contributes importantly to its exempt purpose."

67. *Supra* note 64.

68. *Supra* note 64.

69. Similarly, the pay parking lot was held related in that it also promoted visitation. *Supra* note 65. One might also envision a weekly three-ring circus complete with clowns and fire-eaters. Such a spectacle would surely draw all available visitors to the hospital—the ultimate in supportive therapy.

70. *Supra* note 10.

Rulings, that factor was partially overlooked. The Commissioner did place some weight on the fact that the general public was not encouraged to use the cafeteria and not permitted to use the parking lot, which indicates that the facilities were not operated as a typical, commercial enterprise. But does this mitigate against the existence of competition? Should not a hospital cafeteria be placed on a par with the restaurant across the street? Shouldn't the gift shop compete on equal tax grounds with other gift shops in town? The element of competition is less important with regard to the parking lot since proximity to the hospital and an absence of adequate on-street parking made any possible competition unlikely. The element of competitive equality, however, was largely ignored by the Commissioner.⁷¹

An important area of conflict regarding unrelated trade or business involves nonprofit associations formed for the purpose of promoting a particular sport, business, or city. It is not uncommon for organizations to stage annual or periodic trade shows, fairs, or athletic contests for the dual purpose of promoting their exempt purpose *and* making money. Since such affairs are normally staged periodically, and are of such scale as to reap large profits, any discussion of unrelated business income taxation must consider both regularity and relatedness of such activity, and most importantly, the effect such conduct has upon competing enterprises.

The general area of trade shows sponsored by associations pledged to promoting the best interests of a particular trade or profession has been a controversial subject in recent years.⁷² A 1967 Ruling set out the general rules governing trade shows,⁷³ stipulating under what circumstances income from trade shows will be deemed income from an unrelated trade or business. A trade show typically involves the exhibition of products or

71. Similarly, the "comparative size and extent" of activity test set out in Treas. Reg. § 1.513-1(d)(3) was also ignored. One would imagine that if this test were used, the result would be a small proportion of income attributable to the business activities in question, and thus, a finding of relatedness. For a general discussion of a hospital's operation of a pharmacy for the convenience of its patients, which is specifically excepted from the definition of unrelated business under Code section 513(a)(2), see Rev. Rul. 68-374, 1968-1 CUM. BULL. 242 and Rev. Rul. 68-375, 1968-1 CUM. BULL. 245. For a comprehensive definition of what constitutes a "patient" under the Code, see Rev. Rul. 68-376, 1968-1 CUM. BULL. 246.

72. See generally Miller, *Taxation of Trade Shows, Insurance Programs and other Income Producing Activities of Non-Profit Organizations*, in TAX PROBLEMS OF NONPROFIT ORGANIZATIONS 219 (Webster ed. 1968); Webster and Lehrfield, *The Current Tax Treatment of Trade Shows: Attacks Now Being Made by the IRS*, 25 J. TAX. 10 (1966).

73. Rev. Rul. 67-219, 1967-2 CUM. BULL. 210.

services of a particular trade or business and is directed either to the public or to a particular class of customers depending on the trade or business involved. The object of a show is the promotion and stimulation of demand for a particular product or service. An important factor of relatedness of trade shows is that they must be of general rather than specific import; they must be directed toward the "improvement of business conditions for the industry generally,"⁷⁴ not primarily for individual benefit, and not for the purposes of making sales.⁷⁵

Income from trade shows is derived principally from charges for rental of exhibit space and admission. Members and non-members of the trade association must be charged the same fees for exhibit space or the proviso that the show be conducted for the industry generally will be violated.⁷⁶ Receipts are used to defray the cost of the show; any profit may go to the exempt association to be used for its exempt purpose. Although according to the Regulations a profit making motive rather than a purpose to promote the exempt function may be found where the business activities of an organization account for a relatively large portion of the organization's income,⁷⁷ the Commissioner has had little success in applying this quantitative standard against trade shows in arriving at the qualitative determination.⁷⁸

74. *Id.* The ruling goes on to specify that: "The shows [must be] conducted in a manner reasonably calculated to accomplish that objective [stimulation of interest and product demand], and not merely to promote the individual products of the exhibitors. They are not conducted to provide exhibitors a mart or facility for making sales of their products or services to persons attending the show."

75. *Id.* See Treas. Reg. § 1.513-1(d)(4), example (3) (1967). Miller, *supra* note 72, at 228, gives the following guidelines to prevent imposition of unrelated business income tax, or even loss of exemption, due to a finding that sales were promoted at a show: "The Service also looks at whether or not salesmen are present in the display booths instead of technical personnel, although it is not clear whether the presence of salesmen who do not make sales on the spot will lead to the show being treated as unrelated. In addition, the make-up and general appearance of exhibit booths may lead to a determination that the purpose of the show is selling. For example, the presence of cash registers and order blanks in booths would indicate a selling purpose. . . . The literature aimed at potential exhibitors should not emphasize sales opportunities, and, in fact, it is wise to include in any leases for exhibit space a prohibition against the making of sales at the trade show." But see *American Woodworking Mach. & Equip. Show v. United States*, 249 F. Supp. 392 (M.D. N.C. 1966) (promotional literature distributed to potential exhibitors proclaimed the opportunity for making sales, yet the organization retained its exemption).

76. Miller, *supra* note 72, at 211.

77. Treas. Reg. § 1.513-1(d)(3) (1967).

78. See, e.g., *Texas Mobile Home Ass'n v. Commissioner*, 324 F.2d 691 (5th Cir. 1963) (the court intimated that income from a trade show amounting to seventy-five per cent of the association's annual earnings was income from a related business).

While it is certain that when properly run a trade show operates to the competitive disadvantage of no one and does contribute importantly to the exempt function of a trade association, it is much less certain that the "leasing" of a name of an exempt organization to a professional producer of trade shows accomplishes the same purpose. Such a setup is pregnant with commercialism and may ultimately result in the exploitation of the organization's tax-exempt status.

In *Orange County Builder's Association, Inc. v. United States*⁷⁹ this type of operation was held acceptable. Plaintiff was a nonprofit business league incorporated under the laws of California, organized and operated for the purpose of improving conditions in the Orange County construction industry. Plaintiff's many exempt activities included maintenance of a library containing texts on construction and related fields, consultation with local governments on proposed revisions of building codes, and maintenance of a special room where contractors could prepare bids and specifications. The list is far from exhaustive.

During the years of 1955-62 plaintiff's income was derived principally from dues. However, 9% to 18% of its gross income was received from George Colouris Productions, a professional producer of trade shows, in return for plaintiff's authorization of the use of its name in the production of the Orange County Home Show. By the terms of the contract Colouris was to handle the production and plaintiff was designated as sponsor. In 1955 plaintiff was to get 10% of the gross receipts from the show; in 1956 and subsequent years plaintiff was entitled to 8% of the first \$20,000 of gross receipts and 15% of any amount in excess of that sum. Plaintiff never actively engaged in producing the show, but only leased its name and accompanying good will. The Commissioner attempted to impose the unrelated business income tax, but the court denied imposition on two grounds: first, sponsorship of the trade shows did not constitute trade or business, and second, sponsorship of the shows was related to the exempt function of the association.

The decision is weak on both holdings, but no in-depth probing into the decision is possible as no account of the court's reasoning is included in the decision. First, there is little difference between sponsorship of a trade show and active production of a trade show—which is a business (since trade shows are normally and commercially conducted on a seasonal basis).⁸⁰ Also, on the second point, it would not be denied that, had

79. 65-2 U.S.T.C. ¶ 9679 at 96,828 (S.D. Cal. 1965).

80. See generally Treas. Reg. § 1.513-1(b) (1967) and Treas. Reg. § 1.513-(c) (2) (1967).

plaintiff conducted the show on its own behalf, such conduct would be related to the association's exempt function. The products and services exhibited were directly related to the construction industry and were viewed by members and others in the construction industry, as well as by the general public. The show also "substantially contributed to the stimulation of construction activities in Orange County, California."⁸¹ Since the construction industry was benefited, plaintiff's exempt function was promoted. The weakness of the holding lies in the Commissioner's placing no importance on the commercialization and commercial exploitation of the exempt organization's name, something tantamount to the Red Cross leasing its name to a commercial pharmacy or ambulance service.⁸²

Another group of cases and Rulings involving problems similar to those of the trade shows also involves an exempt association sponsoring an annual or periodic fund-raising event. In one Ruling⁸³ an organization formed for the purpose of "promoting and conserving the best interests and true spirit of a game as embodied in its traditions" was judged to be engaged in a related business where it derived substantial income from dues, championship tournaments, grant of radio and television rights, and sales of booklets on the rules of the game. All the above income-producing activities except sale of radio and television rights were ruled by the Commissioner to promote the exempt function of the organization and were thus related business activities. The radio and television rights produced relatively insubstantial revenue when compared to the size and extent of the exempt activities and therefore were "deemed" unrelated under Regulation section 1.513-1(d)(3).

The case of *Mobile Arts and Sports Ass'n, Inc. v. United States*⁸⁴ is similar to the above Ruling insofar as it illustrates how the amount of money an exempt organization may earn tax-free depends upon the nature of the exempt function, the commercial appeal of the subject matter of the exemption, and the ingenuity of promoters in making a commercial venture look charitable. Plaintiff was suing to force the Commissioner to grant it an exemption either as an educational corporation or a civic organization. All the income of the organization was derived from the plaintiff's staging and sponsoring of an annual football game known as

81. *Supra* note 79, at ¶ 96,829.

82. Exploitation of the name or good will of an exempt organization is proscribed by Treas. Reg. § 1.513-1(d)(4)(iv) (1967).

83. Rev. Rul. 58-502, 1958-2 CUM. BULL. 271. "The organization is empowered to prescribe and enforce the rules and tests governing amateur standing and the rules for the playing of the game, and to hold each year championship tournaments and other events as may from time to time be arranged." *Id.* at 272.

84. 148 F. Supp. 311 (S.D. Ala. 1957).

the "Senior Bowl Classic." The civic benefits claimed by plaintiff included: (1) favorable publicity for the city; (2) the attraction of tourists; and (3) the providing of inspirational value to the city's youth. The organization's charter stipulated that no profit was to inure to the benefit of any individual and all profit be reinvested in the community. Tickets were sold to the general public at from \$3 to \$6, but twenty-five percent of them were set aside for sale to grade school children at \$.50 each for the avowed purpose of stimulating interest and encouraging participation in recreational activities. Some income was earned from the sale of program advertising; however, a large percentage of ad space was gratuitous and used to advertise other nonprofit activities which contributed to the welfare of the community. Films of the game were distributed across the nation free of charge. Although the suit was one to acquire exemption, the words of the court speak in terms of relatedness of the business to the exempt function of the organization:

The conducting of the Bowl game was and is an integral part of MASA's civic and educational program and bears a close and intimate relationship to the civic and educational objects for which MASA was organized.⁸⁵

The lesson is clear. If an organization wishes to generate the greatest amount of money tax-free, it should choose an exempt purpose capable of being commercialized, then stage a game or show exhibiting some aspect of the exempt function. The profit may be used in its entirety for the exempt purposes of the organization on the grounds such programs "educate" the community or "foster" the true spirit of the sport.

One word of warning, however, the Commissioner does not recognize a horse racing meet as being on the same educational par with football. In a 1968 Ruling, the Commissioner decreed that a county fair association, exempt under section 501(c)(3) of the Code derived related business income from its two-week horse racing meet featuring pari-mutuel betting conducted in conjunction with its county fair program.⁸⁶ The Commissioner found that racing was a trade or business because it was conducted similar to commercial racing enterprises, and was regularly sponsored as a seasonal business.⁸⁷ Income was received from gate admission, sale of programs, and a percentage of the total amount wagered. After disbursements for purses and other racing expenses, net income was used solely for the exempt purposes of the association. The racing was deemed

85. *Id.* at 316.

86. Rev. Rul. 68-505, 1968-2 CUM. BULL. 248.

87. Compare this interpretation of "business" with the contradictory holding in *Orange County Builder's Ass'n v. United States*, *supra* note 79, and accompanying text.

unrelated business because horse racing and accompanying betting does not contribute importantly to the educational purposes of a county fair, and was intended to raise money rather than attract the public to the educational features of the fair.⁸⁸

There is little difference between staging a football game and running a horse racing meet. Both are acceptable sporting events. Horse racing promotes and inspires interest in the development of fine breeds of horses. The only plausible explanation for the differing treatment and creation of a double standard by the Commissioner is that a value judgment was made declaring football of inherent educational value and horse racing not. If the Commissioner did find moral fault with the betting, he could have segregated those receipts and permitted the gate, program, and concession receipts to have been received tax-free.

STATUTORY EXCEPTIONS TO UNRELATED BUSINESS INCOME

By virtue of section 512(b)(3) of the Internal Revenue Code all rents from real property are excluded from unrelated business income, including rents from personal property rented along with the real property, so long as the amount attributable to the personal property is "incidental" in comparison to the total amount of rents under the lease. If more than fifty percent of the total rent is attributable to the personal property, then according to Code Section 512(b)(3)(B), the real property rental exclusion shall not apply. For example, hypothesize an exempt organization which regularly rents its meeting hall to individuals or other organizations, supplying only utilities and janitorial services. Such rental income is excluded under Code section 512(b)(3).⁸⁹ If personal property in the form of tables, chairs, and eating utensils is rented with the hall, and the value of such personalty is incidental when compared to that portion of the rent attributable solely to the bare premises, the rental attributable to the personalty is also excluded. However, where that portion of rent attributable to the personalty is fifty percent or more of the

88. *Supra* note 86. Compare this Ruling with *Maryland State Fair and Agricultural Society, Inc. v. Chamberlain*, *supra* note 40, at —, where a jury decided that "the production of horses and the development of their fine points and their capacities, whether as draft horses, or as fast race horses, is ordinarily comprehended by the term 'agriculture'." Plaintiff was an agricultural association which staged the annual Maryland State Fair. Horse racing was held for a one-week period. One of the purposes of the exempt association was "the breeding of fine strains of horses, whether as draft horses or race horses."

89. Rev. Rul. 69-178, 1969-1 CUM. BULL. 158: "Since the charges in this case are made for the use and occupancy of space in real property and only utilities and janitorial services are provided, the receipts constitute rental income."

total rent, the rent in its entirety is considered unrelated business income on the ground that personality rather than realty is being leased.

The Regulations provide that where services are provided in connection with the rental of real property, funds received will not constitute rents from real property within the ambit of Regulation section 1.512(b)(3)(A)(i).

Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.⁹⁰

The furnishing of maid service, for example, is not customarily provided in a lease for purposes of occupancy, while janitorial servicing of common passageways and public entrances and the furnishing of utilities are customary.

Where excessive services are provided, the exempt organization will be disallowed an exclusion and a tax will be levied on the unrelated income. An adverse Ruling was handed down in 1969 to an exempt organization created for the stimulation and fostering of public interest in the fine arts by promoting art exhibits, sponsoring cultural events, conducting educational programs, and disseminating information relative to the fine arts.⁹¹

The organization occupied a large building housing offices, galleries, music rooms, a library, a dining hall, and studio apartments where artists lived and worked. Only artists occupied the rooms; only a few of them were members of the organization and the rooms were not made available on the basis of membership in the organization. Services provided the tenants included maid service, switchboard service, and dining facilities. Because these services were rendered, the Commissioner held payments by the tenants not to be "rents" within the meaning of Code section 512(b)(3)(A)(i).⁹²

Although the Ruling is directly in line with the Regulations, one might question the rationale for excluding from the term "rents" the money paid for housing when services are also rendered. It would seem, in such a case, that the rents might be apportioned among the various services and the cost of the apartment. Money attributable to the cost of the services might be included in unrelated business income while that attributable to the naked lease could be excluded. This is a more equitable method than "tainting" the entire amount.

It appears also that a strong case could be built for deeming income in the above case to be substantially related. One might analogize the exempt

90. Treas. Reg. § 1.512(b)-1(c)(2) (1958).

91. Rev. Rul. 69-69, 1969-1 CUM. BULL. 159.

92. *Id.*

function of "fostering the arts" to the unrelated tax treatment of hospitals. By providing space and services to artists, leisure time and a suitable environment for creativity are provided which does in fact causally relate to promotion of the arts. The Commissioner made an issue of the fact that apartments were not rented on the basis of membership in the organization, but this is immaterial insofar as the exempt purpose of the organization is to foster the arts in general and not just the artistic achievements of the composite membership. If the underlying reason for taxing the income was the creation of a competitive disadvantage with respect to other tax-paying landlords, the Commissioner ought to have based his decision upon this factor. Also, since an exclusion is allowed for incidental personal property leased along with the real property,⁹³ there is no sound reason why an exclusion should not lie for incidental services rendered in conjunction with a lease.

Section 512(b)(2) of the Code provides an exclusion for all royalties from computation of unrelated business taxable income. The Regulations provide that a working interest coupled with a share of the development cost in mineral property *is* includable in unrelated business taxable income.⁹⁴ This issue was faced in a 1969 Ruling⁹⁵ requested by an exempt organization owning a working interest in oil and gas producing properties. An agreement with an independent developer provided that the organization was relieved of its share of development costs, but that it was obligated to pay a share of the operating costs. Noting that the Regulations were silent as to whether liability for a share of operating costs removed the agreement from the term "royalty" as used in the Code, the Commissioner found the implication that any *active* working connection with the property would be fatal: "To be a royalty interest, the right to payment must be free of both development and operating costs."⁹⁶ The rule promulgated, then, is that where property is leased for investment purposes, the exempt lessor must surrender all active or working control;⁹⁷ the investment must remain completely passive. The rationale

93. INT. REV. CODE OF 1954, § 512(b)(3)(A)(ii).

94. Treas. Reg. § 1.512(b)-1(b) (1958) provides: "[W]here an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded."

95. Rev. Rul. 69-179, 1969-1 CUM. BULL. 158.

96. *Id.*

97. Working interests in real property resulting in imposition of unrelated business income tax is not restricted to mineral interests. *See, e.g.,* Rev. Rul. 58-482, 1958-2 CUM. BULL. 273 (trust property consisting of orchards was partly leased to an independent tenant and partly operated by employees of the trust under

behind the rule is obviously the avoidance of unfair competition. If an exempt organization were to in effect pass on part of its exemption to independent mineral developers, or to go into the developing business on its own, the effect would be to place independent developers at a distinct competitive disadvantage.

An interesting example of avoidance of the above result was given judicial sanction in *United States v. Robert A. Welch Foundation*,⁹⁸ an action to recover taxes alleged to be erroneously collected. Plaintiff was an exempt foundation set up as part of a decedent's estate. Twenty-eight percent of the estate consisted of risky oil and gas property, the income therefrom being subject to the unrelated business income tax. Motivated by the risk, tax consequences, and management difficulties, the foundation and estate decided to convert the working interests into a net profits overriding royalty. A contract was consummated between the foundation and a company owned by the estate, whereby the company would "operate, manage, and deal with the properties" at cost, and merely account to the foundation and legatees of the estate for the net profits applicable to their respective interests.⁹⁹ The foundation retained no liability for the property. The court ignored reality and viewed the foundation and the developing company as separate entities. It held that overriding royalties had effectively been created, and that plaintiff had severed itself from active operation of the oil and gas interests. In 1969, the Commissioner denounced this variation of the pea and shell game and announced that the Internal Revenue Service would "continue to review exempt organizations' transfers of mineral properties to controlled corporations and characterize the payments according to the substance of the transaction regardless of form."¹⁰⁰

CONCLUSION

The subject area of the unrelated business income tax has become very confused. While it is certain that the paramount reason for Congressional imposition of the tax was to equalize the business activities of

direct supervision of the trustee. The income derived from that part of the orchard operated by the trust was held to be unrelated business income).

98. 228 F. Supp. 881 (S.D. Tex. 1963), *aff'd per curiam*, 334 F.2d 774 (5th Cir. 1964).

99. *Id.* at 883. Section 3 of the contract provided: "The reserved royalty interests are and shall be an overriding royalty, as the case may be, equivalent to all (100%) of the net profits realized by Fidelity from oil, gas and other minerals produced, saved and marketed from the leased premises and attributable to the conveyed interests."

100. Rev. Rul. 69-162, 1969-1 CUM. BULL. 158.

tax-exempt organizations with business activities carried on in regular commercial channels, it is even more certain that the Internal Revenue Service has largely lost sight of this fact. Rulings, decisions, and court cases seldom ground decisions on this basis. Instead, the Treasury Department has promulgated a raft of Regulations focusing on such immaterial factors as causality, commerciality, and regularity, none of which may be directly and positively linked to the existence of or promotion of unfair competition with private enterprise. Conversely, at times the Regulations and Rulings in fact sanction and even advance commercial disadvantage to private business. To permit an educational foundation to print and market books, or a hospital to operate a pharmacy, ignores the reality of a causally related exempt function competing in the commercial world. Tests and standards must be evolved which would impose tax on the unrelated business income of an exempt organization only where a commercial disadvantage be proved.

Absent this, a second and less favorable alternative would be to scrap the various tests of relatedness—"conducted like a commercial enterprise," "promotes the efficiency of the exempt function," and "contributes importantly to the exempt purpose,"—in favor of the more manageable standard of "causal relatedness." The Internal Revenue Code imposes a tax when a negative qualitative relationship exists between a certain business and a particular exempt function, but under present practice, this test is not uniformly followed. At the very least, the Regulations must be modified so that only one particular test is to be uniformly applied when it is to be determined whether a business is or is not substantially related to a particular exempt function.

Finally, the concept of "regularity" of unrelated business activity also needs substantial revision. As the Regulations now stand, various vague quantitative factors ("intermittent," "recurring," "sporadic," "annual") combine with a comparison to frequency of commercial activity ("seasonal") and an analysis of promotional efforts employed ("systematically" and "consistently") to create a monster of the simple concept of regularity. Also, the single venture must be statutorily declared taxable so as to avoid the ludicrous but rationally sound result that a single unrelated business venture is business regularly carried on. Probably the most equitable and practical manner of arriving at a workable definition of regularity would be to set a ratio between gross exempt receipts of an organization and the amount of unrelated income that could be earned annually. An organization which exceeded this ratio would be taxed on the entire amount of unrelated business income (less the \$1000 exclusion), which would be deemed regularly carried on. In short, the

massive confusion created by the multitude of tests and standards applied to the concepts of "substantially related" and "regularly carried on" must be simplified in the interests of greater predictability and competitive equalization.

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